

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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PLR-136313-07

Date:

January 10, 2008

### LEGEND:

Taxpayer =

State =

Act I =

Act II =

Trust =

Trust Agreement =

Plan =

Board =

Dear :

This is in reply to your letter of July 30, 2007, and subsequent correspondence, in which you request various rulings on behalf of the Taxpayer with respect to its Plan and Trust.

Board is an instrumentality of State and was established pursuant to Act I. Act II directs State and Board to create an irrevocable trust for the purposes of holding, investing, and distributing assets to be used for certain post-employment health care benefits. Board is administrator of Plan, a self-insured comprehensive health benefit plan serving eligible active and retired State employees and their dependents. To carry out Plan, Board established Trust according to Trust Agreement. Trust Agreement provides that Board serves as the plan administrator for Plan.

Board is currently governed by an eleven-member board of directors that is composed of five members of State Personnel Board, the Director of State Finance Department, the Secretary-Treasurer of the Employees' Retirement System of State, two elected active State employees, and two elected retired State employees. State Act II provides that Board members will serve as trustees of Trust.

State, through Board, provided the initial funding for Trust. Additional contributions to Trust may be made from: (a) appropriations by State Legislature; (b) contributions by employees and retired employees; (c) employer contributions; (d) investment income; (e) proceeds of any gifts, grants or contributions; (f) transfers from State Employees' Insurance Trust; and (g) any other source permitted by law. You represent that Trust assets are used solely for the payment of health care benefits on behalf of eligible retirees, their spouses, and dependents who participate under Plan and for the payment of the cost of administering Plan and Trust. There are no individual participant accounts under the Plan. Moreover, State has adopted an amendment to its Constitution to limit the use of Trusts in Trust to providing health care benefits and to prevent the Legislature from withdrawing any of the Trusts held in Trust.

Trust generally cannot be amended, except under very limited circumstances with a majority vote of the trustees, so long as such amendment is consistent with the legislative intent of Act II. Trust may be terminated by a majority vote of the Trustees only if all State plans or programs providing such post-employment health care benefits for which Trust is established are repealed or terminated and there is no future obligation of State to provide such post-employment health care benefits. Upon termination of Trust, any assets remaining after satisfying its obligations to participants and any remaining liability of Trust shall revert solely to State to and for the credit of Board.

You represent that to become eligible for retiree health benefits under the Plan, a retiree must have at least ten years of service to State and receive a monthly benefit from the State Employees' Retirement System, the Teachers Retirement System of State, or the State Judicial Retirement System. No person other than eligible retirees of the Taxpayer, their spouses or dependents as defined in § 152 (determined without regard to §152(b)(1), (b)(2), and (d)(1)(B)) may receive benefits from the Plan. Retirees will receive health insurance benefits from the Plan until (1) a retiree becomes eligible for Medicare, at which point the Plan becomes secondary to Medicare, or (2) equivalent medical insurance coverage from another employer of the retiree becomes available and the employer provides at least fifty percent of the cost of single health insurance coverage. In the latter case, the former employee will be required to obtain coverage under the new employer's health plan. In addition, you represent that Trust funds will

be used solely for the payment of health insurance premiums on behalf of eligible retirees of the Taxpayer, their spouses and dependents and not for any other benefit now or in the future. Eligible retirees will not receive any amounts in cash or any other taxable or nontaxable benefits.

Under the Plan, coverage is generally paid for jointly by the employer and its retired employees. Retirees will be required to contribute a portion of the insurance premiums paid by the Taxpayer to the Trust based on a percentage of the retirees' wages. You represent that employee contributions to the Trust are mandatory for all employees who will derive a benefit from the Plan. The amount of the employee contribution and the amount of health insurance premiums paid by the employer will be determined by the Board. Contributions will not be subject to any election by the employee. Further, no contributions will be made by employees or retirees through salary reduction agreements. Contributions of the value of paid time-off days and cash-outs are also not permitted under the Plan. In addition, the plan provides that upon the death of the retiree, the surviving spouse and eligible dependents may continue coverage by continuing to make the required premium payments. All health benefits terminate on the death of the deceased retiree's spouse and dependents or the failure to pay the premiums.

#### LAW AND ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a state or any political subdivision of a state.

Under Rev. Rul. 77-261, 1977-2 C.B. 45, the income from an investment fund, established under a written declaration of trust by a state for the temporary investment of cash balances of the state and its political subdivisions, was excludable from gross income for federal income tax purposes under § 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utilities or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign properly to conduct. In addition, pursuant to section 6012(a)(2) and the underlying regulations, the investment Trust, being classified as a corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, trusted, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under § 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Trust provides health benefits to eligible retired State employees and their dependents. Providing health benefits to current and former employees constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of §115(1) of the Code.

The income of Trust accrues to the benefit of the State. State is the sole participating employer in Plan. Trust's assets will be used only for administrative expenses and expenditures in providing health care benefits to eligible Plan participants. No private interests participate in or benefit from the operation of Trust. Any distribution of remaining Trusts in Trust to participating employees upon the dissolution of Trust satisfies an obligation State and Board have assumed with respect to providing health benefits to State employees. The benefit to the participating employees is incidental to the public benefit. See Rev. Rul. 90-74.

Section 61(a)(1) of the Code and §1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 106(a) of the Code provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1(a) of the regulations provides that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in § 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in § 105(e)) which provides accident and health benefits directly or through insurance to one or more of his employees. However, if the insurance policy, trust or fund provides other benefits in addition to accident or health, § 106 applies only to the portion of the contributions allocable to accident or health benefits.

Coverage provided under an accident and health plan to former employees and their spouses and dependents is excludable from gross income under §106. See, Rev. Rul. 62-199, 1962-2 C.B. 38; Rev. Rul. 82-196, 1982-2 C.B. 53.

Based on the information submitted and the representations made, we conclude as follows:

(1) Income of the Trust is derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of § 115(1). Accordingly, Trust's income is excludable from gross income under § 115(1) of the Code.

(2) Amounts paid to the Trust and amounts paid from the Trust which are used solely to pay for health insurance premiums of retired employees and their spouses and dependents as defined in § 152 (determined without regard to §152(b)(1), (b)(2), and (d)(1)(B)) are excludable from gross income under §106 of the Code.

No opinion is expressed concerning the Federal tax consequences of the Trust or Plan under any other provision of the Code other than those specifically stated herein. In addition, no opinion is expressed concerning whether Plan satisfies the nondiscrimination requirements under section 105(h) of the Code.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Harry Beker  
Chief, Health and Welfare Branch  
Office of Division Counsel/  
Associate Chief Counsel  
(Tax Exempt & Government Entities)

cc: